

**Internal Revenue Service**

**Department of the Treasury**

District  
Director

Delaware-Maryland District

31 Hopkins Plaza, Baltimore, MD 21201

Person to Contact:

Contact Telephone Number:

In Reply Refer to:

Date: **MAY 1 - 2000**

**CERTIFIED MAIL**

Dear Applicant:

We have considered your application for recognition of exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code and have determined that you do not qualify for exemption under that section. Our reasons for this conclusion and the facts on which it is based are explained below.

You incorporated in the State of [REDACTED] to be organized exclusively for charitable, religious, educational and scientific purposes, including, for such purposes, the making of distributions to organizations under section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future federal tax code.

Article [REDACTED] of your Bylaws state: "...all corporate powers shall be exercised by or under the authority of the Board of Directors, and the management and affairs of the Corporation shall be controlled by the Board of Directors."

Article [REDACTED] of your Bylaws state: "The officers of this corporation shall be a president, secretary and treasurer, each of whom shall be elected by the Board of Directors. A Chairman of the Board, Vice President, and such other officers and assistant officers as may be deemed appropriate may be elected by the Board of Directors from time to time. Any two of more offices may be held by the same person. A failure to elect a President, Secretary, or Treasurer, shall not affect the existence of the Corporation."

"The officers of the corporation shall be elected annually by the Board of Directors at its meeting after each annual meeting of Members. If the election of officers shall not be held at such meeting, such election shall be held as soon thereafter as conveniently may be. Each officer shall hold office until his or her successor shall have been duly elected and shall have qualified, or until his or her death, or until he or she shall resign or shall have been removed in the manner hereinafter provided."

Article [redacted] of your Bylaws state: "The Board of Directors may, by resolution passed by a majority of the whole Board, designate an Executive Committee and one or more other committees. The Executive Committee (if there is one) shall consult with and advise the Officers of the Corporation in the management of its affairs, and shall have and may exercise, to the extent provided in the resolution of the Board of Directors creating such Executive Committee, such powers of the Board of Directors as can be lawfully delegated by the Board."

The Board of Directors and officers of the corporation are as follows:

- [redacted] President
- [redacted] Vice President/Secretary
- [redacted] Chairman of Board
- [redacted] Treasurer (wife of Antonio Canaan)
- [redacted] Vice Chairman of the Board (relative of Joanne Turner)

Page 2 of Form 1023 states you will provide mental health and psychiatric treatment services to provide relief of the poor, distressed and/or underprivileged population. Provide services pertaining to mental health and substance abuse prevention education. Provide psychological testing and research utilizing psychological tests to establish outcome measures and research for the advancement of psychiatric and mental health treatment.

[redacted] (hereafter referred to as [redacted]) is an outgrowth of [redacted] (hereafter referred to as [redacted]) a for-profit. [redacted], President of [redacted], owns [redacted] % of [redacted].

Further clarification disclosed that: "The type of counseling you provide to [redacted]'s clients is not different than the type of counseling offered at a commercial enterprise. It is top quality counseling provided by top quality counselors. You want to offer all [redacted] services at no cost to those who otherwise would not be able to receive mental health services. To be able to do that, we are pursuing funding from state contracts and grants. Currently, [redacted] is eligible for several contracts at no cost to clients who meet the criteria of having no mental health benefits with their insurance, no insurance and/or cannot afford to cash pay the standard fees for services at a commercial enterprise."

You stated: "Currently, [REDACTED] does not have a specific fee schedule as we will be providing services under funding that allows us to treat people at no cost or little cost to them as some funding may require a minimal co-pay of \$[REDACTED] per treatment session."

"[REDACTED] and [REDACTED] are linked in that they share office space, administrative staff, and some counseling staff. [REDACTED] is currently trying to secure funding to begin full operations with its own staff. Until then, [REDACTED] is offering [REDACTED] these services at no cost. When funding is secured, [REDACTED] will begin to pay its portion of those services used to be determined when the full implication (amount of office space, staff, etc) is known. [REDACTED] and [REDACTED] are also linked in that both have the same president in [REDACTED]."

Subsequent information revealed that [REDACTED] will utilize the following fee schedule"

Individual/Family sessions per 50 minute hour	\$[REDACTED]
Group sessions per 90 minutes	[REDACTED]
Psychiatric evaluations	[REDACTED]
Medication management per 15 minutes	[REDACTED]
Case management per hour	[REDACTED]
Educational classes per class	[REDACTED]
Psychological testing per hour	[REDACTED]
Research will be based on a per job basis	

Your letter dated [REDACTED] stated: "In the matter of compensation, [REDACTED], [REDACTED], and [REDACTED] will be receiving compensation for professional services they will offer to [REDACTED] only. It has been decided that their salaries will not be determined by the Board of Directors, but will be determined by the Executive Committee based on industry standards and monitored by a Quality Assurance Program.

Income will be derived from contributions, grants and fees for services and expended for salaries and occupancy. [REDACTED] will pay annual salaries to [REDACTED], [REDACTED] and [REDACTED] of \$[REDACTED], \$[REDACTED] and \$[REDACTED], respectively. [REDACTED] and [REDACTED] are employees and principals in [REDACTED].

Section 501(c)(3) of the Internal Revenue Code provides for exemption from Federal income tax for organizations which are organized and operated exclusively for charitable, religious, and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to qualify for exemption under section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. Failure to meet either the organizational or operational test will disqualify an organization from exemption under section 501(c)(3).

Section 1.501(c)(3)-1(c)(1) of the Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish such purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Thus, in construing the meaning of the phrase "exclusively for educational purposes" in Better Business Bureau v. United States, 326 U.S. 279 (1945), the Supreme Court of the United States stated, "This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations states that an organization is not organized or operated for any purpose under section 501(c)(3), unless it serves a public rather than a private interest. Thus to meet the requirements of this subparagraph, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests. Moreover, even though an organization may have exempt purposes, it will not be considered as operating exclusively for such purposes, if more than an insubstantial part of its activities serve private interests.

In B.S.W. Group v. Commissioner, 70 T.C. 532 359 (1978), the court held that an organization that provided management and consulting services to nonprofit organizations at fees set to cover costs and yield a 10.8 percent profit was not organized and operated exclusively for charitable and educational purposes. Furnishing the services at cost or above cost lacked the donative element to be considered charitable. The court also stated that the presence of substantial profits constitutes evidence that an organization is operating for a commercial rather than exclusively educational purpose.

In Est of Hawaii v. Commissioner, 71 T. C. 1067, the Tax Court found that an organization, which engaged in activities relating to "est", programs involving training, seminars, lectures, etc., in areas of intrapersonal awareness and communication did not qualify for exemption under IRC 501(c)(3) of the Code. The organization's activities were conducted under a licensing agreement with for-profit corporations and thus served the commercial purposes of the for-profit corporation. The organization was simply an instrument to subsidize the for-profit corporations and not vice versa and had no life independent of those corporations.

In International Postgraduate Medical Foundation v. Commissioner, 56 TCM 1140, T.C. Memo 1989-36, the founder of an exempt organization and for-profit entity was in a position to use the exempt entity to benefit his for-profit business. The exempt organization contracted with the for-profit business to perform services on its behalf. The court stated that when a for-profit entity receives benefits from an exempt organization, the exempt organization is not operated exclusively for charitable or any other purposes no matter how many exempt activities it conducts.

In KJ's Fund Raisers, Inc. v. Commissioner, T. C. Memo 1997-424 (1997), affirmed 82 AFTR 2d 7092 (1998), the Tax Court found that another gaming organization was not exempt. While the organization raised money for charitable purposes, it also operated for the substantial benefit of private interests. The organization's founders Kristine Hurd and James Gould, were the sole owners of a bar, KJ's Place. The organization, through the owners and employees of KJ's Place, sold lottery tickets exclusively at KJ's Place during regular business hours. While in KJ's Place the lottery ticket purchasers were sold beverages from the bar. The initial directors were Hurd, Gould and a related individual. The initial board was replaced several times until Hurd and Gould were no longer on the board. At all times Hurd and Gould were the organization's officers. Salaries had been paid to Hurd and Gould and rent had been paid to KJ's Place.

The organization maintained that the fact that salaries and rent were no longer paid in this fashion indicated the independence of the board. The Court took another view.

Although those practices ceased and are not in issue here, the current board of directors is composed of at least the majority of the same members who allowed those amounts to be paid. This strongly suggests that Hurd and Gould are free to set policy for their own benefit without objection from the board. Nothing in the record since July 1, 1994 indicates otherwise.

The Court concluded that KJ's Fund Raisers was operated for substantial private benefit and did not qualify for exemption. The Court of Appeals affirmed the decision. It found that the organization had served the private interests of its directors in maintaining and augmenting their business interest.

Leon A. Beehly v. Commissioner, 35 T. C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest and there is a purpose to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

In Mabee Petroleum Corporation v. United States, 203 F.2d 872, 877 (5th Cir. 1953), the court states that in determining whether the salaries and other benefits paid by an organization to its officers are reasonable, all facts and circumstances must be considered. One factor to consider is whether comparable services would cost as much if obtained from an outside source in an arm's length transaction.

Old Dominion Box Co. v. United States, 477 F.2d 340 (4th Cir. 1973), cert. Denied 413 U.S. 910 (1973) held that operating for the benefit of private parties constitutes a substantial nonexempt purpose.

In P.L.L. Scholarship v. Commissioner, 82 T.C. (1984), an organization operated bingo at a bar for the avowed purpose of raising money for scholarships. The board included the bar owners, the bar's accountant, also a director of the bar, as well as two players. The board was self-perpetuating.

The Court reasoned that since the bar owners controlled the organization and appointed the organization's directors, the activities of the organization could be used to the advantage of the bar owners. The organization claimed that it was independent because there were separate accountings and no payments were going to the bar. The Court was not persuaded.

A realistic look at the operations of these two entities, however, shows that the activities of the taxpayer and the Pastime Lounge were so interrelated as to be functionally inseparable. Separate accountings of receipts and disbursements does not change that fact.

The Court went on to conclude that the organization had a substantial nonexempt purpose.

Revenue Ruling 72-369, published in Cumulative Bulletin 1972-1, on page 245, holds that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations does not qualify for exemption under section 501(c)(3) of the Code. An organization is not exempt merely because its operations are not conducted for the purpose of producing a profit. To satisfy the operational test of the Regulations, the organization's resources must be devoted to purposes that qualify as exclusively charitable within the meaning of section 501(c)(3) of the Code. The organization was not exempt because it was carrying on a trade or business of the type ordinarily carried on for profit.

Revenue Ruling 75-91, published in Cumulative Bulletin 1976-1, on page 140, provides that where the purchaser is controlled by the seller or there is a close relationship between the two at the time of the transaction, the presumption is that the agreement cannot be made because the elements of an arm's length transaction are not present.

Based upon the facts submitted and cited published precedence, we hold that your organization does not operate within the purview of section 501(c)(3) of the Code.

#### **ISSUE 1 – PRIVATE BENEFIT/INUREMENT**

The inurement proscription contained in Regulations 1.501(c)(3)-1(d)(1) states that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Inurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to the accomplishment of exempt purposes.

Inurement of income is strictly forbidden under section 501(c)(3) without regard to the amount involved. This proscription applies to persons who because of their particular relationship with an organization have an opportunity to control or influence its activities. Such persons are considered "insiders" for purposes of determining whether there is inurement of income. Generally, an organization's officers, directors, founders, and their families are considered "insiders".

A self-perpetuating governing body controls the organization. Although an Executive Committee is in place, *the Committee is selected/elected by the Board of Directors, thereby nullifying the Committees' control.*

Hence the compensation arrangement lacks the elements of an arm's length transaction since the agreements are set by the recipients rather than through an independent third party based on objective criteria. This arrangement is similar to the one discussed in the cited precedent where the court stated that this compensation arrangement permitted the net earnings to inure to the benefit of private individuals. The court also stated that in this type of situation, the organization served private rather than public interests as required by section 501(c)(3) of the Internal Revenue Code.

## ISSUE 2 – BUSINESS ACTIVITIES

A review of your fee schedule demonstrates that your method of operation will not differ from those of a commercial enterprise. The factual purpose of your organization is to solicit contributions to offset your business fees. [REDACTED] acts as a conduit for the for-profit through shared office space; administrative staff and counseling staff.

Even though a true charitable purpose may exist, your substantial private benefit and business activities defeat exemption. Therefore, we have concluded that you do not qualify for exemption from Federal income tax as an organization described in section 501(c)(3) of the Code. In accordance with this determination, you are required to file Federal income tax returns on Form 1120.

Contributions to your organization are not deductible by donors under section 170(c)(2) of the Code.

In accordance with the provisions of section 6104(c) of the Code, a copy of this letter will be sent to the appropriate State officials.

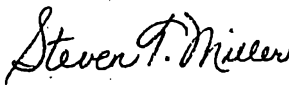
If you do not agree with our determination, you may request consideration of this matter by the Office of Regional Director of Appeals. To do this, you should file a written appeal as explained in the enclosed Publication 892. Your appeal should give the facts, law, and any other information to support your position. If you want a hearing, please request it when you file your appeal and you will be contacted to arrange a date. The hearing may be held at the regional office, or, if you request, at any mutually convenient district office. If someone who is not one of your principal officers will represent you,

If you don't appeal this determination within 30 days from the date of this letter, as explained in Publication 892, this letter will become our final determination in this matter. Further, if you do not appeal this determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust administrative remedies. Section 7428(b)(2) of the Code provides, in part, that "A declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

Appeals submitted which do not contain all the documentation required by Publication 892 will be returned for completion.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,



Steven T. Miller  
Director, Exempt Organizations

Enclosure: Publication 892

cc: State Attorney General